

XII. REMEDIATION

As demonstrated in this Report and in others, the City's longstanding systemic deficiencies have led to repeated violations of laws and regulations and to decisions that have been fiscally irresponsible. The failures have had enormously negative consequences for the City's reputation, infrastructure, and current and future generations of taxpayers. Yet these deficiencies and failures were shielded from public attention by misleading, inaccurate and unreliable financial statements and debt financing disclosures. These weaknesses have transcended several administrations and call into question both the management of the City's financial accounting systems, and, at core, whether anyone is accountable. The Audit Committee understands the current City administration is attempting to address some of these shortcomings, and we commend the Mayor for using his new office to raise public awareness of the various issues facing the City. The tide of San Diego history, however, seems always to favor the status quo.

The City's dramatic failures have received widespread national public attention. The events discussed in this Report have in whole or in part been covered by at least a dozen reports issued in connection with previous investigations.¹²⁶¹ Several of the investigations conducted by government authorities have resulted in individual prosecutions. The City cannot gain access to the public debt markets. The cost of all this has been staggering, in terms of the expense to the City and its taxpayers and in the erosion of municipal services.

Despite this history, the City has yet to fully grasp, much less meaningfully address, the urgent need for changes in the City's organization and structure to prevent a recurrence of these practices and to instill a culture of compliance. By its own recent admission, the City still lacks internal controls that are

¹²⁶¹ See, e.g., City Attorney Michael J. Aguirre, Interim Report No. 1 Regarding Possible Abuse, Fraud and Illegal Acts by San Diego City Officials and Employees (Jan. 14, 2005); Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code (Sept. 16, 2004); City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials (Feb. 9, 2005); Luce, Forward, Hamilton & Scripps LLP, Legal Research Concerning Certain Pension-Related Issues for the City of San Diego (Feb. 22, 2005); City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund (Apr. 8, 2005); Supplemental Memorandum from Luce, Forward, Hamilton & Scripps LLP to P. Lamont Ewell, City Manager, City of San Diego and Lynn E. Turner (May 12, 2005); City Attorney Michael J. Aguirre, Interim Report No. 5 Regarding the Legal Status of the Elected Officers Retirement Program (May 18, 2005); City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme (July 1, 2005); Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals (Draft July 15, 2005); City Attorney Michael J. Aguirre, Wastewater Interim Report No. 1 City of San Diego Officials' Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity (Sept. 15, 2005); City Attorney Michael J. Aguirre, Interim Report No. 7 SDCERS Attorney-Client Privilege Documents Released Under Federal Court Order (Dec. 6, 2005); Navigant Consulting, Inc., Investigation for the Board of Administration of the San Diego City Employees' Retirement System (Jan. 20, 2006); Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System (Jan. 20, 2006).

adequate to assure timely and accurate financial reporting. A report issued by the City Auditor and Comptroller, on January 1, 2006 (“City Auditor 2006 Report”), made the following candid acknowledgment:

As of our report date, we are unable to conclude that the City’s internal controls over financial reporting are adequate to assure timely and accurate financial reporting.¹²⁶²

Put in context, over three years after the City was warned by the Blue Ribbon Commission of serious deficiencies in its funding of its pension system and almost two years after these deficiencies were quantified by the Pension Reform Committee, the City today remains incapable of providing reliable financial reports to purchasers of its bonds and the City’s taxpayers. Equally troubling, according to the City Auditor 2006 Report, for the City’s 2003 CAFR, it will be necessary to make more than two dozen journal entries to correct prior errors in the City’s accounting records, in the aggregate amount of \$641 million.¹²⁶³ At the same time, bank reconciliations have not been performed in a timely manner, preventing the City from knowing the general ledger cash balance.¹²⁶⁴ The City’s 2002 financial statement still cannot be reconciled with the City’s final 2002 ledger.¹²⁶⁵ The chart of accounts used by the City is not regularly updated. In fact, despite the pressing need for the City’s issuance of its 2003 CAFR, at a meeting in June 2006 that included representatives of the City, its independent auditors and the Audit Committee, it became evident the City

¹²⁶² Office of the Auditor & Comptroller, City of San Diego Annual Report on Internal Controls (Jan. 1, 2006).

¹²⁶³ Office of the Auditor & Comptroller, City of San Diego Annual Report on Internal Controls, Appendix C at 85 (Jan. 1, 2006).

¹²⁶⁴ Office of the Auditor & Comptroller, City of San Diego Annual Report on Internal Controls, Appendix B at 81 (Jan. 1, 2006).

¹²⁶⁵ The City Auditor & Comptroller’s 2006 Report identified the following weaknesses in the City’s internal controls:

- Two-thirds of the Audit department staff reported to one person.
- Responsibilities for CAFR preparation were allocated among a large number of individuals.
- Business processes were not formalized or documented.
- Data was not accessible.
- There was a lack of automated processes, including a lack of an automated financial system that provided easy access and adequate documentation.
- There was a lack of adequate training, including both technical and operational training.
- Accounting staff were isolated from the City departments for which they were responsible.
- Audit independence may be compromised by having the auditor hired by and reporting to the Chief Executive Officer under the strong mayor form of government.
- There was a lack of adequate communication between departments and Audit personnel.
- There was an absence of accounting expertise in several departments, particularly in the service departments, because of over-centralization of accounting functions in the Auditor’s office.

Office of the Auditor & Comptroller, City of San Diego Annual Report on Internal Controls at 4-9 (Jan. 1, 2006).

had not yet provided information previously requested by the auditors for the completion of the audits of the 2003 and 2004 CAFRs, including outstanding bank reconciliations for the fiscal year ending 2003. Thus, astonishingly, two years after such financial statements should have been completed by the City and submitted to the appropriate federal authorities, for reasons having nothing to do with the need for investigation into its illegal conduct, the City remains in default under OMB Circular A-133, which requires recipients of federal grants to file their audited financial statements within nine months of fiscal year end.¹²⁶⁶

These weaknesses carry over into the City's budgeting and planning process. From the standpoint of a public understanding of the City's financial condition, the City's budget is one of the most important documents produced by the City as part of its financial statements. In his budget for the fiscal year ending 2007, the Mayor proposed the City prepare and adopt a five-year plan,¹²⁶⁷ an innovation we strongly endorse. The budget process nonetheless has had a number of significant shortcomings. An enormous volume of information in multiple binders is given to the City Council in February or March when the budget is first proposed.¹²⁶⁸ The proposed budget is refined in budget hearings in April and May, before appropriation ordinances must be adopted by the end of July. Historically, budget year reports showing budget-to-actual comparisons with year-to-date amounts, by department, are not regularly provided to the City Council. The Audit Committee has been informed that, at times, year-end adjustments are made to the

¹²⁶⁶ Office of Management and Budget (OMB) Circular No. A-133, Audits of States, Local Governments, and Non-Profit Organizations states:

Subpart B – Audits
§ 225 Sanctions.

No audit costs may be charged to Federal awards when audits required by this part have not been made or have been made but not in accordance with this part. In cases of continued inability or unwillingness to have an audit conducted in accordance with this part, Federal agencies and pass-through entities shall take appropriate action using sanctions such as:

- (a) Withholding a percentage of Federal awards until the audit is completed satisfactorily;
- (b) Withholding or disallowing overhead costs;
- (c) Suspending Federal awards until the audit is conducted; or
- (d) Terminating the Federal award.

¹²⁶⁷ City of San Diego, Budget and Management Services, Fiscal Year 2007 Proposed Budget at 7, *available at* <http://www.sandiego.gov/budget/proposed/pdf/initiatives.pdf>.

¹²⁶⁸ Until December 31, 2005, the City Manager was responsible for preparing the budget. San Diego City Charter art. V, § 28. According to Council members we have interviewed, under the prior practice the proposed budget was presented in multiple binders, containing an enormous amount of detail, organized in such a manner that important matters were not readily apparent. Interview by the Audit Committee with Brian Maienschein (May 12, 2006); Interview by the Audit Committee with Donna Frye (May 3, 2006); Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006); Interview by the Audit Committee with Toni Atkins (Apr. 28, 2006).

budget to eliminate variances among departments or for other purposes, without adequate explanation or approval. Because long-range budget planning has been virtually non-existent, the practice of addressing shortfalls in the budget by underfunding long-term liabilities, such as the retirement system, receives little attention from the City Council or the public.

The City's deficiencies in accounting, financial reporting, and budget planning and analysis has resulted in the City issuing numerous financial statements and debt financing disclosure documents that did not comply with the federal securities laws, GAAP and other legal requirements. In the absence of significant remediation, were the City to attempt to enter the debt market by, for example, issuing pension obligation bonds (as has been proposed in its 2007 budget) it is very likely, because of interest rates and the City's credit rating, these bonds will have to be issued at high interest rates.¹²⁶⁹

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The City's credit rating from each of the three credit rating agencies are as follows:

- Standard & Poor's Ratings Services suspended its ratings and underlying ratings on San Diego's bonds, general-fund-backed lease underlying ratings, all water- and sewer-revenue bonds, and all outstanding bonds and short-term notes of all city entities, excluding the city's Housing Authority and Area Housing and Finance Agency, as of September 20, 2004. *S&P Suspends San Diego Ratings*, The Wall Street Journal (Sept. 21, 2004).
- On May 27, 2005, Fitch Ratings downgraded the City of San Diego's \$22 million in outstanding general obligations bonds to "BBB+" from "A"; \$250 million in leased backed debt to "BBB-" from "A-"; San Diego Public Facilities Financing Authority (1) \$1.1 billion in sewer revenue bonds to "BBB+" from "A" and (2) \$287 million in subordinate water revenue bonds from "BBB" to "A-"; and San Diego Facilities and Equipment Leasing Corporation \$287 million in certificates of undivided interest to "BBB+" from "A". Fitch also lowered the ratings of (1) San Diego certificate of participation refunding bonds, series 2003; (2) San Diego Metropolitan Transit Development Board lease revenue bonds, series 2003; (3) Convention Center Expansion Authority lease revenue bonds, series 1998A; and (4) San Diego Public Facilities Financing Authority lease revenue bonds, series 2002B, to "BBB-" from "A-". Fitch also lowered the San Diego Public Facilities Financing Authority (1) sewer revenue bonds to "BBB+" from "A" and (2) the subordinate water revenue bonds to "BBB" from "A-"; and the San Diego Facilities and Equipment Leasing Corp. certificates of undivided interest, series 1998 to "BBB" from "A." *Fitch Lowers \$1.95B of San Diego, California Debt: Remains on Watch Negative*, FitchRatings (May 27, 2005).
- On February 16, 2006, Moody's affirmed the City's ratings and retained a negative outlook on those ratings. The 1991 Public Safety Communications Bonds and the 1994 Open Space Park Refunding Bonds were rated A3. The 1994 City/MTDB Lease Revenue Refunding Bonds; the 1996 A and B - Balboa Park/Mission Bay Park Capital Improvements and Refunding; the 1998A - Convention Center Expansion; the 2002B - Fire and Life Safety Facilities Project; the 2003 - 1993 City/MTDB Lease Revenue Refunding Bonds; and the 2003 - 1993 Balboa Park/Mission Bay Park Refunding bonds were rated Baa2. The 1996A (Taxable) - Jack Murphy Stadium certificates of participation and lease revenue bonds were rated Baa3. The Certificates of Undivided Interest in Installment Payments for the water revenue bonds were rated A2. The Subordinated Water Revenue Bonds, Series 2002 were rated A3. The Sewer Revenue Bonds Series 1993, 1995, 1997, 1999A and 1999B were also rated A3. *Moody's Affirms Ratings on City of San Diego, California Obligations*, Moody's Investors Service (Feb. 16, 2006).

It should be noted that funding the City's obligation to its retirement system with proceeds from the sale of pension obligation bonds does not do away with debt; it merely shifts the risk of non-payment from the system's beneficiaries to investors.

SDCERS has likewise suffered from the same deficiencies in accounting and financial reporting. As detailed above, for six consecutive years the SDCERS CAFRs contained a false and misleading description of the system funding mechanism. The SDCERS Board, so far as the Audit Committee can discern, delegated responsibility for the CAFRs' accuracy to the system administrator and a handful of outside professionals. As we have seen, these professionals came under inappropriate pressure to compromise their professional judgment to serve the City's short-term budgetary needs. By abdicating its role as independent overseer with ultimate responsibility for accurate financial reporting, the SDCERS Board deprived the system of whatever "gatekeeper" function these professionals might otherwise have provided.

In summary, the City and SDCERS have financial reporting and control processes that are inadequate, lack transparency, and are not supported by sufficient competent resources. With this background, the Audit Committee proposes the following Remediation Plan. The Remediation Plan seeks to achieve four principal compliance objectives, described more fully below:

- Enhanced accountability;
- Greater transparency;
- Increased fiscal responsibility; and
- Independent oversight.

In developing the plan, the Audit Committee reviewed recommendations made in previous reports; made inquiry of interviewees with relevant experience, and with representatives of the City and SDCERS for suggested recommendations; and considered usual and best practices in financial reporting, management and governance. In the area of financial reporting and control processes, significant elements of the Remediation Plan are derived from the recommendations and formal pronouncements of widely-respected bodies, such as the Government Finance Officers Association, the Institute of Internal Auditors, and the American Institute of Certified Public Accountants. A listing of each specific recommendation in the Remediation Plan is set forth in Appendix M.

A. Enhanced Accountability

Enhanced accountability begins with improvements in information systems. The time-honored expression "you manage what you measure" seems an apt description of the importance of reliable, relevant information in a system in which decision-makers are to be held accountable. To enhance accountability in San Diego government, the Remediation Plan requires measurable steps to install an infrastructure with internal controls to gather and report relevant financial information on a timely basis. Because the system must remain robust in the face of inevitable human error, the Remediation Plan provides for the recruitment and continuous training of specially skilled individuals, delineates lines of supervision, and

recommends independent oversight of the system to ensure breakdowns are identified and addressed promptly.

1. Reorganization of Financial Reporting¹²⁷⁰

The Mayor has established the position of Chief Financial Officer (“CFO”) for the City. The Audit Committee commends and strongly supports him for taking that action. Ultimately, someone within City government must be accountable for the accuracy and credibility of the City’s financial reporting. We believe that should be the CFO, along with the Mayor as the Chief Executive Officer of the City.

The Audit Committee found the City’s financial reporting structure deficient, primarily because it lacks clear lines of responsibility and systems to generate the financial data in an efficient and reliable manner. The engine for this system is also sadly lacking: qualified employees with current training in the preparation of financial statements that meet legal standards. This, in turn, has contributed to major breakdowns in internal controls, which are necessary for any organization if it is to be a responsible participant in the U.S. capital markets. To address this urgent need, the City should redefine with reasonable clarity areas of responsibility and lines of supervisory authority among management and departments for (i) accounting and financial reporting, (ii) treasury, and (iii) planning, budgeting and financial analysis. Under the Remediation Plan, as described below, the auditing and oversight functions will be independent of the other departments responsible for financial reporting.¹²⁷¹

a. The Chief Financial Officer of the City (“CFO”)

The CFO should have primary responsibility for, and have as direct reports, personnel with functional authority over, accounting and financial analysis, treasury, planning and budgeting and financial reporting.¹²⁷² This should include authority over those responsible for all information systems required by these functions. The CFO should have significant experience with governmental operations, including accounting, financial reporting and applicable disclosure standards, rules and regulations. The CFO should in particular have experience in the preparation of a CAFR in accordance with governmental accounting standards and offering statements for a municipal issuer.

b. City Comptroller

The Comptroller should report to the CFO and be responsible for accounting and financial reporting, including preparation of the City’s CAFRs. The Comptroller should have significant experience in

¹²⁷⁰ An organizational chart reflecting the Audit Committee recommendations is included as Appendix N.

¹²⁷¹ This will require amendment of the City Charter. See Appendices M and N.

¹²⁷² We also understand the current CFO is contemplating establishing a separate group to manage the City’s debt.

governmental accounting, including in the preparation of CAFRs in accordance with GASB and other applicable accounting and financial reporting standards, rules and regulations. The Comptroller should in particular be familiar with the federal rules and regulations applicable to the receipt of federal assistance and the issuance of public securities. The Comptroller should also be competent to design, implement and operate an effective system of internal controls over financial reporting and disclosure.

c. Director of Financial Reporting

The Comptroller should have, as a direct report, a Director of Financial Reporting responsible for the preparation of the City's periodic financial statements. Such person should also have experience in the preparation of CAFRs in accordance with GASB and other applicable accounting standards, rules and regulations.¹²⁷³

d. Director of Planning, Budgeting and Financial Analysis

The Director of Planning, Budgeting and Financial Analysis ("Budget Director") should report directly to the CFO and have principal responsibility for preparing an annual budget, a monthly budget with comparisons of budget to actual results year-to-date, analyses of variances, and a quarterly report to the City Council and public setting forth budgeted versus actual results. The Budget Director's Office should serve as a resource for financial analysis, planning assistance, and services to other City departments and agencies.

e. City Treasurer

The City Treasurer should report to the CFO and have principal responsibility for all treasury functions for the City. The Office of the Treasurer and the duties assigned to that Office shall be as otherwise described in the City Charter.¹²⁷⁴

2. Additional Recurring Responsibilities of the CFO and Others

a. Training

It is crucial for the City not only to attract and retain personnel with appropriate levels of experience for its finance and accounting functions, but also to provide them with adequate training. It is impossible for accountants to remain current with developments in accounting and financial reporting

¹²⁷³ The Audit Committee finds nothing necessarily inconsistent between this recommendation and the establishment of a Financial Reporting Division within the Auditor and Comptroller's Office, as authorized by the City Council in August 2005, as part of a proposed reorganization of that office, so long as the internal audit function is removed from the City Comptroller's Office. Minutes, San Diego City Council Meeting at 48 (Aug. 8, 2005).

¹²⁷⁴ San Diego City Charter art. V, § 45.

standards, rules, and regulations without ongoing training. In the accounting profession, 40 hours per year of continuing education is the accepted norm. Yet the City Auditor's 2006 Report noted:

In fiscal year 2004, the total training budget for the Auditor-Comptroller's office was approximately \$4600; actual funds spent totaled \$1,250.67, an average of \$16.25 per professional employee...In a profession with highly technical and frequently changing principles and applications, the City has placed inadequate importance on training and in relying on the adequacy of employees' previous knowledge base.

Obviously, the City has not made the investment necessary to maintain the competency of its staff, which is essential for credible financial management, external and internal financial reporting, and reliable public disclosure. The Audit Committee understands this lack of investment will continue with the budget for the fiscal year ending 2007. To address this urgent shortcoming, we recommend as part of this Remediation Plan the CFO, in consultation with two newly created entities – the Auditor General and the Audit Committee¹²⁷⁵ – assume oversight authority for an effective annual training program for the financial reporting staff who report to them.

The same can be said of training for employees carrying out programs funded by grants and loans. We recommend tailored training for all individuals who are currently employed by the City who were members of the MWWD at any time from 1995 to 2004, the period of the City's noncompliance with its SWRCB grant and loan covenants and its violation of the Federal Clean Water Act. Many of these employees had or should have had knowledge of the City's noncompliance and the possible ramifications of such noncompliance, but failed to take sufficient corrective steps. The MWWD employees should receive special training directed at (i) ensuring the City complies with all contractual requirements, laws and regulations, and (ii) reporting any noncompliance to the appropriate individuals or entities.

b. Information Technology

By no later than June 30, 2007, the CFO should evaluate the information technology needs of the City, including benchmarking of existing systems against available systems suitable for responsible management of the City's finances and the preparation of timely and accurate CAFRs and budgets as described above. Within 18 months the City shall have selected a new information system and taken all steps necessary for the system's implementation. Within 36 months, the City's new financial information system shall have been fully tested to ensure effectiveness and efficiency and will be implemented.

As part of the process of upgrading its information technology, the City should also update its chart of accounts, including elimination of unnecessary accounts and funds.

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One of the remediation measures we recommend as part of this Remediation Plan is the creation of a permanent Audit Committee. This Audit Committee will be a new entity, and should not be confused with the Audit Committee of the City of San Diego, the authors of this Report.

c. Internal Control Testing and Independent Verification

Correcting the serious deficiencies in the City's accounting internal controls is a process that will require a sustained effort. The City would be well advised to devote the next year to correcting the deficiencies and report to the public on its progress. In the following year, the City should retain an independent auditor to perform an audit of its internal controls and issue a report thereon. To reduce the cost of this process, that audit can be accomplished while the auditors are performing the annual audit of the City's financial statements. After the initial independent assessment of internal controls in 2008, the City can determine the frequency of such audits in the future. The expense of periodic audits of internal controls, in the view of the Audit Committee, pales by comparison to the enormous direct and indirect costs to the City from the deficiencies in controls that exist today.

Accordingly, no later than June 30, 2007, the CFO shall have tested and remediated the internal control weaknesses identified in the Auditor and Comptroller's 2006 Report, and in the management letters of the City's outside auditors, KPMG and Macias Gini & Company LLP.¹²⁷⁶ The CFO should submit to the Mayor and City Council, and disseminate to the public, a report that describes testing that has been completed, remediation undertaken, any internal control weaknesses not yet remediated and additional material weaknesses identified.

A reputable independent auditing firm should be retained by the City's new Audit Committee (described below), which should, in connection with the annual audit of the financial statements of the City for the fiscal year ending June 30, 2008, conduct an audit of the City's internal controls, in accordance with the applicable auditing standards, and issue a report thereon.¹²⁷⁷ Such report should, among other things, identify any material weaknesses and be included as part of the City's CAFR.

d. Annual Management Report by Mayor, CFO and Subordinate Accounting Officers

Ultimately, the accuracy and completeness of the City's CAFRs and offering documents, and the systems and controls necessary for them, are the responsibility of the Mayor and the CFO. Accountability for these important tasks properly rests with them. Thus, the Audit Committee recommends as follows:

The Mayor and the CFO should annually include in the City's CAFR a signed management report on the financial statements and disclosures which shall include: (i) a statement of the City's responsibility for establishing and maintaining an effective system of internal control over financial reporting and disclosures; (ii) a statement setting forth the City's assessment of the effectiveness of the internal controls as of the fiscal year-end, as well as identifying any material weaknesses in internal controls; (iii) a statement

¹²⁷⁶ See Appendix M.

¹²⁷⁷ American Institute of Certified Public Accountants, AICPA Professional Standards, at § 501 (July 12, 2006).

that, based on their knowledge, the CAFR does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the CAFR, in light of the statements made and circumstances under which they are made, not misleading with respect to the period covered, and (iv) a statement that this financial statement and other information included in the CAFR fairly present in all material respects the net assets and activities of the City for the period presented.¹²⁷⁸

Certain component units of the City, such as the Redevelopment Agency and SCDERS, issue stand-alone financial statements, and have their results included as part of the consolidated totals for the City. As described above, the SCDERS financial statements frequently did not comply with GAAP, and, as noted in the Auditor and Comptroller's 2006 Report, adjustments in the City CAFR were necessary because of errors in the accounts of the Redevelopment Agency. Therefore, we recommend the chief executive officer and principal accounting officer of each such component unit of the City include annually with its financial statements a signed management report substantially in the form described above for the Mayor and CFO.

e. Ensuring Completeness of Disclosures

In response to recommendations rendered by V&E, the City formally installed a Disclosure Practices Working Group ("DPWG"), comprised of the City Attorney, certain representatives of the City Attorney's office, the Auditor and Comptroller, the City Treasurer, the Deputy City Manager responsible for the financial management functions of the City, and the City's outside disclosure counsel.¹²⁷⁹ The DPWG is responsible for the design and implementation of a program that ensures the City's compliance with disclosure controls and procedures (through an annual evaluation), oversight of mandatory disclosure training of City staff, and review of all City offering documents prepared as part of the City's public disclosure. As an element of this Remediation Plan we endorse the continuation of the DPWG, though we recommend a change in its composition. Given the enormous responsibility of the CFO to ensure the accuracy of the City's financial statements, the CFO should be a member of the DPWG and serve as its chair. As reconstituted, with the DPWG reporting to the City's new Audit Committee, as we also recommend, the DPWG can render meaningful assistance to the City (and particularly to the Mayor and CFO) in discharging their obligations to consider the materiality of information and to determine the City's disclosure responsibilities, consistent with best practices observed in the private sector.

¹²⁷⁸ It has been suggested to the Audit Committee that such reports be an integral part of the Management Discussion and Analysis Section of the City's CAFR. In our view, that would be an informative way to present this information to the readers of the CAFR.

¹²⁷⁹ San Diego Municipal Code § 22.4103 (adopted Oct. 11, 2004).

3. Independent Auditor General

Currently, the functions of accounting and financial reporting are combined with the function of internal auditing in the Office of the City Auditor and Comptroller; in substance, the auditor audits his own work. Such a structure lacks the requisite level of independence widely viewed as essential for a sound financial reporting system.

To address the deficiencies that have been identified with respect to the independence and oversight of the internal and external financial reporting process, the Audit Committee is proposing the creation of an independent internal auditing function, and improved oversight of both the internal and external auditing process. This should also enhance the performance and credibility of these functions, as well as improve communication among the personnel involved. Our Remediation Plan assigns responsibility to the executive branch to make key appointments, and to the legislative branch to approve the appointments and to serve in an oversight role in the process.¹²⁸⁰ The Remediation Plan also depends upon the participation of citizens to ensure the independence of the oversight process, a requirement for any effective auditing function. Our recommendations follow:

The City should create a new position of Auditor General, with responsibility for internal audits of the City's: (1) internal controls; (2) financial accounting, reporting and disclosure; (3) operations; and (4) fraud, waste and abuse. The Auditor General should be nominated by the Mayor and appointed upon the consent of a majority of the City Council. The Auditor General should have experience with government accounting standards, government generally accepted auditing standards, preparation of government annual financial statements, and operational audits. The Auditor General should have a professional certification such as a Certified Public Accountant or a Certified Fraud Examiner.

The Auditor General should report to an Audit Committee (defined below) no less than on a quarterly basis and periodically to the City Council. In addition, the Auditor General should submit annually to the City Council a public report of his activities.¹²⁸¹

¹²⁸⁰ The GFOA has recommended that "[t]he internal audit function should be established formally by charter, enabling resolution, or other appropriate legal means." They have also recommended that "... internal auditors of state and local governments conduct their work in accordance with the professional standards relevant to internal auditing contained in the U.S. General Accounting Office's publication *Government Auditing Standards*, including those applicable to the independence of internal auditors." Finally they recommend that "[a]ll reports of internal auditors, as well as the annual internal audit work plan, should be made available to the government's audit committee or its equivalent." GFOA Recommended Practice, Establishment of an Internal Audit Function (1997 and 2006), Government Finance Officers Association (Feb. 24, 2006).

¹²⁸¹ We are aware that the City commissioned a Report from an independent accounting firm, Mayer Hoffman McCann P.C., regarding alleged improper billing practices. See Appendix Q. A California Grand Jury has investigated the City's use of Service Level Agreements to wrongfully siphon funding from the City's special Enterprise Funds into the City's general funds. The Auditor General should continue to monitor the progress of the investigations and the remediation of the Service Level Agreement issues identified by the Grand Jury. Service Level Agreements *Equal Back Door Funding*, San Diego Grand Jury 2005-2006 (Apr. 25, 2006); County of San Diego, California, Auditor

In order to protect against budget cuts that may unduly constrain the independent auditing process, the City's Audit Committee should approve the annual compensation of the Auditor General and the annual budget for the Auditor General's staff. The Auditor General should serve a term of 10 years, and could be removed from office for cause by the Audit Committee or upon an affirmative vote of three-quarters of the City Council.¹²⁸²

4. Audit Committee

Audit committees, familiar fixtures at companies seeking access to the U.S. capital markets as well as at many private companies, are not unknown to government issuers. Since 1997, the GFOA has recommended that "[e]very government should establish an audit committee or its equivalent."¹²⁸³

The auditor of a state or local government's financial statements must be independent, both in fact and in appearance. A properly constituted audit committee helps to enhance the financial statement auditor's real and perceived independence by providing a direct link between the auditor and governing board.

One important advantage of an audit committee is that it helps to facilitate communication between management, the auditors, and the governing board. An audit committee also limits the reliance governing bodies must place on the technical expertise of the independent auditor. An audit committee is useful, too, in helping to focus and document the government's process for managing the financial statement audit.¹²⁸⁴

In order to ensure objective oversight of the City's financial reporting process, the City should establish a three-member Audit Committee, with two members from the public and one member of the City Council. The two public members of the Audit Committee should have expertise in accounting, auditing and financial reporting and be capable of critical reading of financial statements. The Mayor should appoint the two members of the Audit Committee from the public, and these appointments should be confirmed by the City Council. The Audit Committee should establish a written charter that is made available to the public.

and Controller, Grand Jury Audit of the City of San Diego Metropolitan Wastewater Department Service Level Agreements, Report No. A06-019 (Feb. 2006).

¹²⁸² We note the Comptroller General of the United States is appointed for a fifteen-year term, and is confirmed by the Senate so as to ensure the independence of the position. Budget and Accounting Act, 1921, Pub. L. No. 67-13, 42 Stat. 23-24 (1921).

¹²⁸³ GFOA Recommended Practice, Establishment of Audit Committees (1997 and 2002), Government Finance Officers Association (Oct. 25, 2002), *available at* <http://www.gfoa.org/services/rp/caafr-establishment-audit-committee.pdf>.

¹²⁸⁴ GFOA Recommended Practice, Establishment of Audit Committees (1997 and 2002), Government Finance Officers Association (Oct. 25, 2002), *available at* <http://www.gfoa.org/services/rp/caafr-establishment-audit-committee.pdf>.

Consistent with the established practice for other entities gaining access to money from the investing public, the City's independent auditors should be retained by, report to, and take direction from, the Audit Committee. We would expect that the CFO and Auditor General, as supporting staff to the Audit Committee, would assist in this process. However, the final decision would be that of the Audit Committee.

The Audit Committee should meet quarterly, or more often if necessary, with the City's independent auditors, the City's Auditor General and the CFO. The Mayor, CFO, City Attorney and City Council should have the authority to make requests of the Audit Committee and Auditor General to perform internal audits of material matters they reasonably believe to be warranted. Private sector members of the Audit Committee shall be compensated in an amount set by the Mayor and approved by the City Council.¹²⁸⁵

To discourage any improper influence of the professionals who serve as "gatekeepers" to the public financial reporting process of the City, the Municipal Code should be amended to add criminal penalties for such conduct. It should be unlawful for any elected official, or employee of the City, or anyone acting under their direction, to take any action to corruptly influence, coerce, manipulate or mislead any independent certified public accountant engaged in the performance of an audit of the financial statements of the City or its component units, or outside legal counsel performing services for the City in connection with an offering statement of the City, or any actuary performing an actuarial valuation in connection with the preparation of the City's or SDCERS's CAFRs, or employees of a bond rating agency performing a credit rating of the City's bonds.

5. Ensuring Protection for Whistleblowers

The new Audit Committee should have responsibility for the establishment and monitoring of effective policies and procedures for dealing with "whistleblower" complaints, including an internal hotline. In that regard, the Audit Committee should receive a report of each such complaint and, in consultation with the Auditor General, determine the appropriate course of action. The Auditor General should report to the Audit Committee the results of any investigation and disposition of such complaints. Documents reflecting

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We note that Vinson & Elkins, as part of its report, made two recommendations that have been adopted by the City which bear directly on this aspect of the Remediation Plan. First, as noted above, Vinson & Elkins recommended the creation of a Disclosure Practices Working Group, which we have endorsed as part of this Plan. See San Diego Municipal Code §§ 22.4101-4109. Second, Vinson & Elkins recommended the establishment of a Financial Reporting Oversight Board, with authority to review and evaluate the City's annual report on disclosure controls made by the Disclosure Practices Working Group, the City's independent auditor's management letter (and the City's response), and the City's annual report on internal controls, and also with the authority to recommend procedures for receiving and responding to so-called "whistleblower" complaints related to accounting, auditing or material control matters. See San Diego Municipal Code §§ 26.1701-1704.

We recommend as part of the Remediation Plan that the Financial Reporting Oversight Board be eliminated as redundant because all of its functions (and additional ones) will be assumed by the new Audit Committee.

such an investigation should be preserved in accordance with procedures established by the new Audit Committee.¹²⁸⁶

B. Greater Transparency

1. Selection and Retention of Auditors

It is critical the City obtain a high quality independent audit of its annual financial statements. As noted previously, the creation of an audit committee should enhance the independence of the external auditor. In addition, the City should modify its procurement practices for obtaining the services of outside auditors. The General Accounting Office has noted that, in addition to cost, other factors that should be considered when selecting an independent auditor include the “appropriate professional qualifications and technical abilities; and the results of the bidder’s peer reviews.”¹²⁸⁷ Thus, to ensure that such non-cost factors are given proper consideration in the selection process we recommend that a procurement decision involving the selection of an auditor be accompanied by a statement of the basis for the selection, including the weight accorded costs and any other factors, and that such statement be maintained as part of the records of the new Audit Committee.

Further, to address the perception that long-term engagements erode auditor independence, and that incumbency provides an unearned advantage during the selection process, the new Audit Committee and the City should enter into five-year contracts with its independent auditors. After the initial five-year term, that term could be extended for another five years provided (i) the audit firm rotates the audit partner responsible for the engagement and (ii) the auditor has received an unqualified peer review report on its audits. The audit could also be rebid at the end of five years, and an auditor should not be permitted to serve for more than two consecutive five-year terms.

Finally, to level the playing field among audit firms interested in serving the City, and ensure a focus on audit quality, we recommend that bidders, under certain circumstances, be disqualified. First, an audit firm that, directly or indirectly, through any of its principals or employees, has made a campaign contribution to an elected official of the City within two years of the selection of the auditor should not be considered for an engagement. We likewise recommend that any audit firm that performs other, non-audit services for the City be similarly disqualified. The Audit Committee should be free to adopt policies that impose more stringent selection and retention standards.

¹²⁸⁶ Obviously, if it has been determined that there are violations of the City’s ethics policies, the Independent Audit Committee is free to refer such matters to the appropriate ethics office of the City as well.

¹²⁸⁷ Government Auditing Standards, Roles and Responsibilities, Chapter 1.18(f) (June 2003), *available at* <http://www.gao.gov/govaud/yb/2003/html/chap16.html>.

2. Public Information Regarding Long-Term Liabilities

As detailed in this Report, the sheer magnitude of the City's presently known financial liabilities for such costs as pensions, retiree healthcare and deferred maintenance is staggering. Perhaps even more disturbing has been the lack of public exposure and understanding of these issues and their long-term implications for the City. For example, the Blue Ribbon Committee identified, in addition to pension funding, two other issues – retiree healthcare and deferred maintenance – that if not addressed will almost certainly become the next crisis to befall the City. The Blue Ribbon Committee estimated that the City had not performed its maintenance obligations in an amount exceeding \$300 million. This will have significant consequences as the City simultaneously grapples with a retirement system that is underfunded by as much as \$1.4 billion, and a healthcare obligation to present and former employees of approximately \$1 billion, according to recent estimates.¹²⁸⁸

These looming obligations require the City to develop long-term solutions now. If the public is expected to make sacrifices – and they most surely will – then the public is entitled to know what is coming. Therefore, we recommend the City, as part of its annual CAFR, report (in a separate tabular form) the City's best estimate of material payments it will be required to make for each of the next five years, and in the aggregate thereafter, as a result of (i) contractual commitments or (ii) other commitments the City reasonably intends to fulfill. These payments should include those for (i) expected contributions by the City to the pension plan for retiree pension benefits; (ii) expected payments the City will make for retiree healthcare benefits; (iii) capital expenditures resulting from contractual commitments; (iv) material contractual commitments in excess of one year; (v) deferred maintenance to the extent quantified; and (vi) debt and lease obligations. In the end, the presentation of the information in this form should provide citizens and investors with a credible, transparent picture of the demands on the future cash flows of the City.

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Cheiron, San Diego City Employees' Retirement System, June 30, 2005 Actuarial Valuation for the City of San Diego at 3 (May 16, 2006) (finding that the system's Unfunded Actuarial Liability for the fiscal year ending in June 2005 was \$1.368 billion); Press Release, Office of Mayor Jerry Sanders, *Sanders Announces \$1 Billion Retiree Medical Liability; Liability Grows to \$1.8 Billion in 9 Years* (Mar. 14, 2006).

C. Fiscal Responsibility

1. SDCERS

a. Governance¹²⁸⁹

Large pension systems have been at the forefront of investor demands to improve their governance by strengthening board independence and increasing transparency in financial matters. Government pension funds, particularly SCDERS, should demand no less of themselves. Therefore, the Audit Committee recommends the following changes in the governance structure of SCDERS:

i. Board Composition

As discussed below, as a result of a recommendation by the San Diego Pension Reform Committee, the current composition of the Board is as follows: there are seven citizens who are appointed by the Mayor, in addition to five member-elected representatives and one City Manager Designee. The Audit Committee believes the City of San Diego Pension Reform Committee's recommendation to improve the governance of SDCERS by changing the size and composition of the SDCERS Board was substantially correct.¹²⁹⁰ The Board should be comprised of qualified professionals with experience in the management of investment funds, as well as an understanding of and commitment to the fiduciary responsibilities owed to the System's retirees and employees. At the same time, it must be recognized that employees and retirees, whose contributions helped build the System's assets, have a direct financial interest in the system's welfare unlike any other, and that interest is deserving of respect. Accordingly, we believe the Pension Reform Committee's recommendation to increase the number of outside independent professionals on the Board is an improvement, but further improvements are necessary.

¹²⁸⁹ The Audit Committee is not the first body to have considered and recommended changes to the City's Retirement System, its financing or governance. The Pension Reform Committee, in its report on September 15, 2004, made 17 recommendations for improving the status of the system, including the following change in SDCERS governance:

Change the composition of the Retirement Board to seven members appointed by the City Council. These members will serve with staggered terms of four years each, with a two consecutive term maximum. Such appointees will have the professional qualifications of a college degree and/or relevant professional certifications, fifteen years experience in pension administration, pension actuarial practices, investment management (including real estate), banking, or certified public accounting. Such appointees will be U.S. Citizens and residents of the City of San Diego but cannot be City employees, participants (direct or indirectly through a direct family member) of the SDCERS, nor a union representative of employees or participants, nor can such appointees have any other personal interest which would be, or create the appearance of, a conflict of interest with the duties of a Trustee.

Final Report, City of San Diego Pension Reform Committee at 14-21 (Sept. 15, 2004)

¹²⁹⁰ Final Report, City of San Diego Pension Reform Committee at 42-44 (Sept. 15, 2004) (recommending that the Board be changed to a seven-member body appointed by the City Council, rather than a 13-member body composed of representatives elected by various constituent member groups, management representatives, and appointees).

The composition of the Board of Administration of SCDERS should consist of nine members, including five members who shall be appointed by the Mayor and confirmed by the City Council. We believe a nine-member Board is small enough to encourage collaboration and collegial exchange of views, yet sufficient to oversee the Retirement Plan and the work performed by the approximately 60 employees of SDCERS. Mayoral appointees shall have the qualifications otherwise specified in the City Charter.¹²⁹¹ The remaining four members should consist of: (i) two members elected from police safety members, fire safety members, or general members of the retirement system, selected in accordance with Charter Section 144(d); and (ii) two retired members of the retirement system, selected in accordance with Charter Section 144(e). We note that currently, there are approximately 9,436 current employees of the City covered by the plan as well as 5,995 retirees.¹²⁹²

Given the System's precarious funding and rancorous history, the process of identifying and evaluating prospective SDCERS Board members should be undertaken with greater care than in the past. In connection with SDCERS Board vacancies in 2005, the Audit Committee observed that applicants for appointment were considered by the prior administration on the basis of incomplete, unsigned written forms and inadequate background investigations. In more than one instance, a routine background check performed at the Audit Committee's request revealed that the applicant had been associated with an entity once the subject of a regulatory investigation. We therefore recommend that, prior to any appointment being made to the SDCERS Board, each potential appointee be required to complete a written application listing qualifications for the position and any factors that may impact on that decision, and that the applicants be required to affirm the accuracy of the application. A background check of the applicants to be nominated should be done by the appropriate City department. The applications should also be shared with the Business and Governance Committee of the SDCERS Board.

ii. Board Committees

The Board of Administration should have standing committees to address board governance, compensation and evaluation of the Retirement Administrator, investments, and an audit and compliance committee. We understand that the SDCERS Board has already consolidated its former Business and Procedures Committee with its Rules Committee to form a single Business and Governance Committee, and

¹²⁹¹ San Diego City Charter, art. IX, § 144(a). The qualifications include: "No person who is a City employee, participant in the Retirement System, or City union representative may be eligible for appointment...Such appointees shall have the professional qualifications of a college degree in finance, economics, law, business, or other relevant field of study or a relevant professional certification. In addition, such appointees shall have a minimum of fifteen (15) years experience in pension administration, pension actuarial practice, investment management, real estate, banking, or accounting...Such appointees shall not have any other personal interests which would create a conflict of interest with the duties of a Board member and trustee."

¹²⁹² See Appendix F.

has reconstituted its Audit Committee so that three of its five members will be formally experienced non-Board member citizens of San Diego, one of whom will serve as chair.¹²⁹³ The Board should adopt and publish a formal charter for each of these committees, which should be updated no less frequently than every three years. The charters should ensure the committees perform a board and committee evaluation process on an annual basis. The annual SDCERS CAFR should include a report from each of these committees on significant activities during the year.

b. SDCERS CAFR

The Retirement Administrator and CFO of SDCERS should annually include in the SDCERS CAFR a signed management report on the financial statements which should include: (i) a statement of SDCERS's responsibility for establishing and maintaining an effective system of internal control over financial reporting and disclosures; (ii) a statement setting forth SDCERS's assessment of the effectiveness of the internal controls as of the Plan's fiscal year end as well as identification of any material weaknesses in internal controls; (iii) a statement that, based on their knowledge, the CAFR does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the CAFR, in light of the statements made and circumstances under which they are made, not misleading with respect to the period covered; (iv) a statement that the staff of SDCERS and its Board of Administration are responsible for the adoption of key assumptions used by the SDCERS actuary in the valuation of the system's assets and liabilities; and (v) a statement that the financial statements and other information included in the SDCERS CAFR fairly present in all material respects the net assets and changes in net assets of the Plan for the period presented.

c. SDCERS Financial and Accounting Competency

In the past, SDCERS has lacked sufficient resources to perform its accounting: the SDCERS accounting function has been a mixed responsibility of City personnel and SDCERS. We understand that SDCERS has recently decided to create a full-time Internal Auditor staff position that will report directly to the Audit Committee; a Compliance Officer staff position reporting directly to the SDCERS Board; and the Financial Reporting and Administration Division has been expanded with the addition of four accountants, two of whom so far have significant experience, and a management analyst with advanced training experience.¹²⁹⁴ Given SDCERS's fiduciary responsibilities, which may conflict with those of the City, we concur with actions being taken by the Retirement Administrator to establish a financial reporting function

¹²⁹³ Letter from David B. Wescoe, Retirement Administrator, SDCERS, to Lynn Turner (July 12, 2006).

¹²⁹⁴ Letter from David B. Wescoe, Retirement Administrator, SDCERS, to Lynn Turner (July 12, 2006).

within SDCERS. We recommend the chief accounting officer of SDCERS should have adequate prior experience with investment operations and financial reporting and disclosures. This experience should include a working knowledge of applicable governmental and investment accounting, financial reporting and disclosure standards, rules and regulations, as well as experience with the preparation of the financial statements, footnotes and disclosures required in a CAFR, in accordance with GASB and other applicable standards. The chief accounting officer must be capable of taking primary responsibility for the preparation of the SDCERS CAFR.¹²⁹⁵

Competent management of the system's investments necessarily depends upon the services of skilled investment consultants and fund managers, whose advice should not only be professionally competent, but also free of extraneous influence or conflicts of interest, whether actual or in appearance. We learned in the course of our investigation that a SDCERS Board member had sought information from Callan Associates, Inc. ("Callan"), SDCERS's principal investment consultant, regarding Callan's financial relations with a number of fund managers that had been recommended by Callan and had been managing investments for SDCERS.¹²⁹⁶ Taking the position that such information was confidential, Callan supplied SDCERS with only general information indicating that many of the funds managing SDCERS's investments had been or were engaged in business dealings with Callan, though the specific dollar value and the precise nature of the business dealings were withheld.¹²⁹⁷ The refusal of Callan to fully disclose its financial dealings with managers that it had recommended undermined the ability of the SDCERS Board to competently evaluate the advice it was receiving from Callan as part of its fiduciary obligation to safeguard the system's assets. Such refusal should never again be countenanced.

The Audit Committee recommends SDCERS require its investment consultants and fund managers to annually complete a Vendor Disclosure Form that calls for disclosure of all information regarding remuneration paid or received related to funds managed for SDCERS, as well as its business dealings with the SDCERS investment consultant. In addition, investment consultants and managers should be advised that a failure or delay in filing the annual disclosure will result in a penalty, including termination of services.¹²⁹⁸

¹²⁹⁵ The Audit Committee understands that the person recently elevated to the position of CFO at SDCERS had a long career at the Auditor and Comptroller's Office prior to his appointment as Assistant Administrator at SDCERS in November 2005. Letter from David B. Wescoe, Retirement Administrator, SDCERS, to Lynn Turner (July 12, 2006).

¹²⁹⁶ Interview by the Audit Committee with Diann Shipione (June 21, 2006).

¹²⁹⁷ Interview by the Audit Committee with Diann Shipione (June 21, 2006).

¹²⁹⁸ Other major pension systems have undertaken similar remediation measures. Commonwealth of Massachusetts, Public Employee Retirement Administration Commission, Reform Initiatives Advisory Committee Report at 12-13 (2005).

d. Contributions by the City¹²⁹⁹

The City of San Diego Pension Reform Committee identified a number of reasons for the underfunding of the pension benefits, and made a number of recommendations to address this shortfall. The PRC report and recommendations contributed significantly to the public's understanding of these issues. However, key to all of its recommendations is that the City must balance its sources of revenues and inflows of cash with the costs it incurs and its cash outflows. As with any other costs, this is true for the pension benefits it provides to its employees in return for the services they render. Until recently, the City has refused to actuarially fund the retirement benefits it has granted. In the end, either the City will have to reduce its costs, increase its revenues, or both. Until the City makes a decision regarding this fundamental issue, it will not have successfully remediated the problem.

As an unavoidable imperative, the City should contribute to SDCERS annually the Annual Required Contribution, as calculated by the SDCERS actuary, including an amount sufficient to amortize the existing UAAL over a reasonable period of time that assures that current taxpayers are paying for the full cost of services rendered by employees of the City and not passed on to future generations. For purposes of calculating annual funding requirements, the UAAL should reflect a prudent view of economic reality, and include within it the costs of the *Corbett* settlement. We recommend against using the City's contribution to pay for any benefits other than retirement benefits and the related costs of administering the Plan. Thus, no portion of the City's annual contribution to SDCERS should be credited against the City's obligation to pay retiree healthcare costs, or for any other of the so-called "Waterfall" payments, unless and until the City pays the required ARC. Nor should the City be relieved of the obligation to make annual ARC payments because the system's funded ratio has grown to a level deemed more acceptable, such as the 82.3% MP-1 trigger.

The City's past practice of using SDCERS surplus earnings to fund retiree health care benefits and the administration of the retiree healthcare program violated the Internal Revenue Code, which could both endanger the pension plan's tax exempt status and force the City to repay to SDCERS the funds it diverted from the system to pay retiree healthcare costs. The Audit Committee recommends the City and SDCERS make voluntary disclosure through a self-reporting process to the IRS of the amount of any improper diversion of funds, and cooperate with the IRS to bring the City's retiree healthcare funding into full compliance. We understand that SDCERS has already expressed a willingness to work with the IRS in this regard, and we recommend that the City use all resources at its disposal to assist SDCERS in a joint effort to remedy past errors and maintain a fully compliant retiree healthcare funding structure going forward.

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As noted above, on February 27, 2002, the Mayor's Blue Ribbon Committee issued a report concluding that the City was not paying enough out of its current year budget to fund the pension and retirement health benefits that were being earned by its workforce, and the cumulative shortfall was growing. Later the PRC recommended that the City increase its annual contribution to the pension system to an amount equal to normal cost, UAAL amortization, and contingent liabilities for the year. The City mistakenly failed to take action on these recommendations.

Apart from remedying past tax code violations, the cost of retirement healthcare benefits continues to loom as a long-term liability of potentially enormous proportion. The Audit Committee commends the Mayor for addressing this issue head-on in his 2007 budget, in which he called for the establishment of a retiree health care trust fund.¹³⁰⁰

We recognize that government accounting standards have been slow to adapt to this rapidly changing field. Though the GASB will not require disclosure of retiree healthcare benefits until FY 2008, we commend the City for what we understand to be its decision to make early disclosure of such costs in its next issued financial statement.

e. Retention of SDCERS and City Actuary

Because we place such importance on the City's annual contribution of ARC, as calculated by an actuary, the Audit Committee recommends the City periodically, but no less frequently than every three years, retain its own actuary to review the SDCERS actuarial valuation and the assumptions used, and to provide an independent assessment of the valuation and its implications for the City.

We also recommend that SDCERS rebid the contract for the performance of its actuarial valuation every five years and that the actuary not be engaged for more than two five-year terms. After an engagement for the maximum ten-year term, an actuary should be eligible to be considered for an engagement only after five years of no service to SDCERS.

In addition, the City must retain an actuary responsible for determining for the City the cost of each proposed new retirement benefit, and to issue a report thereon to the City Council before an ordinance is adopted conferring the benefit. The costs should be reflected in the City's annual budget and five-year plan, and variances caused by changes in actuarial assumptions should be explained.

f. SDCERS Legal Counsel

The City's pension crisis can be traced to a series of decisions by the SDCERS Board in which the retirement system's long-term financial interests were sacrificed for the City's need for short-term budget relief. To enhance the likelihood that SDCERS will act for the sole benefit of the system's beneficiaries, independent of the City, SDCERS must be free to retain its own independent legal counsel.¹³⁰¹

¹³⁰⁰ City of San Diego, Budget and Management Services, Fiscal Year 2007 Proposed Budget at 7, *available at* <http://www.sandiego.gov/budget/proposed/pdf/budget.shtml>.

¹³⁰¹ In a case brought by SDCERS against the City and the City Attorney over this very matter, the Court held that "SDCERS is empowered to employ legal counsel of its choosing separate and independent from the City and the Office of the City Attorney of the City of San Diego." As the Court later reiterated in its final ruling denying the City Attorney's motion to reconsider its earlier decision, the Court described at least four factors forming the basis of its conclusion. Final Ruling, *San Diego City Employees' Ret. Sys. v. Aguirre*, No. GIC 841845, at 2-3 (Cal. Super. Ct. May 3, 2006). Those reasons included (i) case law that "establishes that SDCERS is an independent entity from the

g. Funding Method

As noted above, the City, in response to the PRC Report, amended the Charter to require that net actuarial losses be amortized over a period not longer than 15 years, net actuarial gains over a period not shorter than five years, and that SDCERS use an amortization period no greater than a fixed, straight-line five years for each new benefit improvement. We recommend the City use the same period for amortization of both gains and losses.

2. Improvements in Planning, Budgeting, and Financial Analysis

It is by now beyond dispute that the City's planning process and budgeting cannot be counted on to present in comprehensible terms the stark realities the City faces. For over ten years, through MP-1 and MP-2, the City shortchanged the pension system to avoid the impact of necessary pension payments on current budgets and handed the obligation off to another generation of taxpayers. Even today there are items in the City's 2007 budget that have the hallmarks of another looming fiscal obligation of unknown dimension.¹³⁰² We recommend the budgeting and planning process be changed to include the following:

a. Budget Assumptions

The City should publish, along with the annual budget, the significant assumptions that can materially affect the budget, and a comparison of these assumptions against actual experience in recent years. For example, such assumptions ordinarily should include population growth; the number of tax and fee payers; the number, growth and turnover rates of employees; and inflation rates. Any significant variances between actual and projected assumptions should be adequately explained in the final published budget.

b. Monthly Budgeting

The City budget should be presented by month, by department. It should present budget-to-actual comparisons by department, fiscal year-to-date, along with variances on a monthly basis. At least quarterly, a report should be prepared reflecting this information in aggregate, with an explanation of significant variances, to be disseminated to the public.

City;" (ii) the California Constitution's vesting of "sole and exclusive fiduciary responsibility" over the system's assets; (iii) case law regarding the need for boards to be "independent of legislative and executive interference;" and (iv) the City Charter, which provides the Board with the right to, among other things, "appoint such other employees as may be necessary" to discharge its duties in a manner consistent with Constitutional and City Charter requirements. Final Ruling, *San Diego City Employees Ret. Sys. v. Aguirre*, No. GIC 841845 at 2-3 (Cal. Super. Ct. May 3, 2006).

¹³⁰² For example, deferred maintenance. City of San Diego, Budget and Management Services, Fiscal Year 2007 Proposed Budget at 12, *available at* <http://www.sandiego.gov/budget/proposed/pdf/initiatives.pdf>.

At year-end, a budget should be presented to the City Council containing a final budget-to-actual comparison, along with an explanation of variances by department. Inter-departmental transfers to meet budget goals, or for any other purpose, should not be permitted unless approved in advance by the City Council.

c. Five-Year Plan

The CFO and Mayor should submit annually to the City Council as part of the annual budgeting process, a rolling five-year proposed plan that contains major items, including (i) capital expenditures; (ii) deferred maintenance; (iii) debt payments and other major contractual obligations; (iv) major sources of revenue, by category; and (v) a forecast of gross cash receipts and gross cash expenditures.

3. Training

We have already recommended training for employees involved in financial reporting and accounting functions, and have assigned responsibility for this to the CFO. We note that the DPWG has already begun mandatory training of the City staff and elected officials regarding their disclosure obligations under federal and state securities laws. We endorse the remedial actions of the DPWG, but recommend that training be conducted no less frequently than every two years.

4. City Council 14-Day Disclosure Review Period

The City Council is, after all, the governing body that authorizes the City to borrow from the public. It exercises oversight of an enterprise that investors look to for repayment. Like the board of directors of any large public company, the Council has authority over the management of a large work force, and can (and should) hold department and agency heads accountable for failing to deliver services. This duty to perform an oversight role is not optional, nor does it vary depending upon familiarity with the subject matter, or a member's expertise or comfort level. Nor can the duty be avoided by delegation. In accounting and financial reporting matters, the City Council's oversight role requires thoughtful engagement and careful deliberation.

The City Council's oversight function cannot be performed if sufficient time is not allowed to review financing disclosure documents, which can be lengthy and complex. The City Council, which authorize these issuances, is comprised of persons lacking in relevant expertise, who therefore rely heavily on the City staff. Our investigation has shown that the City Council's review of disclosure documents, even when under the watchful eye of members of the City Attorney's Office, has at times been rushed and perfunctory. Nevertheless, the Council members can be rightly criticized for allowing the City staff to lead them through the review process in a hurried fashion, often in closed session, after which materials were collected and no longer readily available to the member. In the final analysis, if the City Council is to share responsibility for the accuracy of the City's disclosure documents, it is absolutely essential that the Council be

given a reasonable opportunity to examine and ask questions about the disclosure documents it is authorizing to be disseminated to the public.

The Audit Committee therefore recommends that the City Council have at least two weeks to review substantially completed drafts of a preliminary offering statement before it is asked to vote to approve the final document. We understand the City may at earlier stages in the process be required to review a draft in good form, to solicit input and comments, which should be encouraged. The City Council members should also establish a reasonable period of time for the review of a final document, with marked changes from earlier drafts. Moreover, because the City CAFR is an integral component of the financial information provided as part of any debt issuance, the City Council should review and approve its use following the same procedures.

D. Oversight by Monitor

This Report recounts a history of repeated government failures. Internal decision-making processes essential for allocating scarce public resources have been corrupted, distorted to serve short term ends, or simply circumvented. Recommendations from previous studies and investigations, such as those of the PRC, have been ignored. By this point, in the face of several pending governmental investigations, there is little reason to have confidence that the City can reform itself. Therefore, the Audit Committee recommends the appointment of a Monitor to oversee the implementation of and compliance with the Remediation Plan.

As set forth in more detail in Appendix M, a City Monitor should be selected by the Mayor in consultation with the City Council and subject to the approval of the SEC, for oversight of the City's compliance with the Remediation Plan. The Monitor should be an independent person of suitable standing, independence and experience for this assignment. The Monitor should have complete and unfettered access to all City and SDCERS personnel and records. The Monitor should make quarterly reports to the City and the SEC on the City's progress. These reports should be made public in an appropriate manner including on the City's website. The Monitor should serve a term of no less than three years and should be provided adequate resources to carry out the duties of his office. The SEC should have the right, upon request, to expand the scope of the Monitor's duties following consultation with the City.

E. Implemented Remediation Measures

1. The Status of Responsible Parties

The City has already taken remedial employment actions with respect to various employees within the City. No person as to whom the evidence supports a finding of wrongful intent is any longer employed by or serving the City.

2. Disclosure Practices Working Group (“DPWG”)

Of the several remediation measures already taken by the City to improve disclosure, internal accounting, and ethical practices, the creation of the DPWG is adopted as part of the Remediation Plan. This DPWG is working to ensure the City complies with federal and state securities laws and to promote high standards of accuracy in disclosures. The DPWG is also tasked with designing and implementing the City’s disclosure controls and procedures and ensuring that City staff and officials receive appropriate training concerning those controls and procedures. The DPWG issued its first annual report addressing the City’s disclosure practices and controls on November 1, 2005. We endorse the continuation of the DPWG, and recommend that it report to the new Audit Committee.

3. Restructuring of Departments

The City has also modified the structure of its Departments and its disclosure procedures. The Municipal Code now provides for a Deputy City Attorney for Finance and Disclosure to supervise those members of the City Attorney’s Office who provide advice to the City regarding finance and disclosure matters.¹³⁰³ The City has created an employee hotline through which employees can make anonymous reports of fraud, waste, abuse, or other unethical behavior. The Remediation Plan specifically adopts these changes as well.¹³⁰⁴

4. SDCERS

Certain remediation measures affecting SDCERS have also been implemented. The composition of the SDCERS Board has been changed to include seven citizens appointed by the Mayor, in addition to five member-elected representatives and one City Manager Designee.¹³⁰⁵ Those seven appointees must have special professional qualifications as well as be free of any conflicts, whether actual or in appearance. Though we regard the City’s recent restructuring of the SDCERS Board as a substantial improvement, it does not go far enough. We propose to eliminate the City Manager designee because the

¹³⁰³ The City Auditor and Comptroller’s Office is also to conduct an annual evaluation of the City’s internal financing controls and submit a report on this issue to the Financial Reporting Oversight Board. Under our Remediation Plan, these functions have been reassigned to the CFO and the Independent Audit Committee.

¹³⁰⁴ The City has also created a Financial Reporting Oversight Board. According to the DPWG’s November 1, 2005 report, the Board has yet to be established, pending completion of this Report. *See* 2004-2005 Annual Report of the City of San Diego Disclosure Practices Working Group at 12 (Nov. 1, 2005). As noted earlier, the Financial Reporting Oversight Board has been rendered redundant by the new Audit Committee that is recommended as part of the Remediation Plan.

¹³⁰⁵ The SDCERS Board was previously composed of one City Manager Designee, one City Auditor and Comptroller Designee, one City Treasurer Designee, six member-elected representatives, and four trustees appointed by the Council. The total number of trustees (13) has not changed.

City's legitimate interest in the management of the retirement system is adequately protected through the appointment of competent, independent Board members.

Finally, the City Charter has been amended to require, as of fiscal year 2008, that, when amortizing net actuarial gains or losses, a period of no longer than 15 years be used for the amortization of losses and that a period of no shorter than 5 years be used for the amortization of a surplus.

The Audit Committee has proposed more than 50 separate remedial measures, which are detailed in Appendix M to this Report. The items listed in Appendix M supplement and expand upon the preceding discussion. Implementing these items will improve the City's operations and support the changes necessary to restore public trust and confidence.